

REGULATORY POLICY INSTITUTE

International Competition Policy Conference, 26th June 2001

Developments in Competition Policy: Mergers and Oligopolies

INTRODUCTION

Nine days ago the Chancellor and the Secretary of State announced a number of further reforms to competition policy in the UK. This was accompanied by open letters to the DGFT and myself; and a commitment to a White Paper in July. Last Wednesday an Enterprise Bill incorporating these reforms was announced in the Queen's speech. This is likely to be on the statute book in under a year.

While some aspects of these reforms concern extensions to the 1998 Competition Act, most notably the proposal to criminalise some cartel activity and introduce custodial sentences, the bulk of the competition reforms relate to mergers and complex monopoly. It is not entirely just good fortune that these are at the heart of what I said I would talk about today, though the timing is somewhat fortuitous.

I want therefore, in relation to each, briefly to summarise the likely changes to the competition regime; and second, consider some of the economic issues involved, where appropriate in an international context.

THE MERGER REFORM PROPOSALS

The merger reform is intended to take ministers out of merger control except in exceptional circumstances which will be quite tightly circumscribed. The Commission will therefore become determinative. The only so-called exceptional public interest (EPI) gateway through which the minister will be able to re-enter the process will relate to defence or national security matters; other gateways can be created, but only with the approval of Parliament and, therefore, in very transparent fashion.

Mergers will probably be judged by a new test – whether the merger leads to a substantial lessening of competition (SLC). There is likely to be scope for an additional consumer interest leg, not necessarily as part of the primary test but possibly as a consideration in determining appropriate remedies.

These two changes will not necessarily have a dramatic effect on outcomes – nearly all mergers have in practice been assessed against a competition criterion as the usual manifestation of the public interest in merger situations, and very few recommendations for remedies have ever been overridden by ministers – but conceptually the changes are more far reaching and will have impact on the openness, consistency and effectiveness of the regime.

Hovering around these highlights of the reforms are a number of other less recognised but important elements.

- 1) A new SLC test would represent an explicit and decisive move to incorporate what most of those consulted felt was the right test, though this will not precisely align the regime

with the test based on market dominance employed by Brussels. Mark Williams will be saying more about such matters later but the adoption of the test used in the US, Australia, and elsewhere is in my view a clear decision in favour of best practice.

- 2) An intriguing, and quite significant issue concerns the inclusion of the so-called consumer interest leg in the new test. Should the test embrace only a significant lessening of competition, on the grounds that this is the means of promoting the consumer interest; or should it also include separate and explicit provision for consumer interests to be taken into account, the implication being that there will be occasions where consumer interest and competition diverge. This debate creates three options: to include consumers' interests as a further criterion in the test, ignore this point altogether; or include it as a factor that may be taken into account in determining remedies where a merger has failed the primary competition test. On the grounds that one simply cannot disregard situations – usually involving networks or information economics – where consumer interests and competition are not synonymous, I believe that the legislation should encompass consumer benefits, and I understand both business and consumer organisations favour this as well; but there could be much greater clarity, and much less opportunity for the authorities to brush over real losses of competition, if additional consumer interest considerations come in at the remedies stage. In any event, such benefits should be included only if they are clear, significant, imminent and not achievable without the merger.

Lurking behind this is a major international debate about the nature or value of competition and, derivatively, of competition policy. The European tradition that has emerged under the ECMR is, or at least is, generally characterised as very competition oriented, with competition as a sufficiently important and ubiquitous mean to the end of economic well-being, that it becomes an end in itself. Clearly the link between competition and the creation of the single market is important here. Moreover the focus on creating or maintaining dominance as a basis for assessing mergers gives the European regime a very structuralist tone, concerned primarily with market shares and barriers to entry, to the exclusion, some would say, of everything else. The US in contrast is increasingly characterised as performance orientated, the key question being to identify the detriment to customers or consumers, with the implication that, absent any such detriment, concentrated markets, barriers, even specific pricing or other practices which appear in some sense anti-competitive may not be of concern.

This may seem odd – the US is generally regarded as very competitive, and as having had a tough competition regime for many many years; and it was the US authorities that developed widely respected and increasingly copied merger guidelines with an emphasis on Herfindahls – a quintessentially structural criterion – in assessing mergers. Against this, a major element in the US regime, albeit not in mergers, is the scope for private actions and triple damages, which is all about the detriments suffered. More recently the storm over Microsoft, and also over some global mergers which have involved both the US and European authorities, appear to a significant degree to reflect differing priorities, with Europe focussing more on competition per se, but US critics (which may or may not

include the higher courts now involved in Microsoft) emphasising the lack of evidence of consumer harm.

Thus the issue of whether to include a consumer interest leg and, if so, how or with what weight, may be thought a detail – significant, but a detail of the new regime (especially since the Commission has had little recourse to this criterion even within the public interest framework of section 84 of the Fair Trading Act) - but in fact it goes to the heart of a very topical and controversial debate. The fact that the problem has tended to arise only infrequently in the past does not diminish its significance, given in particular that the circumstances most likely to involve this issue include information-orientated markets and those with network effects, both of which seem to be coming to ever more prominence.

- 3) Another significant detail relates to the likelihood of a substantial lessening of competition. At present there must be an expectation of an adverse effect on the public interest. I am told that in the early days this was interpreted as in ‘I expect it to rain this afternoon’ ie that is what I think is going to happen. More recently it has been interpreted as being above a 50 per cent probability, ie more likely than not.

I envisage that the same type of probability stance will be reflected in the new legislation, but this is not uncontroversial. Clearly, to start at an extreme, a takeover of a nuclear power company in which there would be good grounds for believing that it would, even fractionally, increase the risk of a nuclear explosion could surely be regarded as against

the public interest even though the Commission did not think the explosion more likely than not. More realistically reflecting an actual case, there was the possibility that the acquisition of Eastern Electricity would have left it so heavily geared that in a deteriorating financial position all the lights in East Anglia would go out. Again an expectation that they would go out is clearly not the right test.

To date, in most respects, this problem has been avoided. In the Eastern Electricity case there was in any event a regulatory regime which would have precluded the dire outcome described; and it would be reasonable, when a dire consequence is involved to argue that it is the increased possibility of it happening that is the expected adverse effect. But this does not eliminate the problem in theory or practice. Consider a merger which results in a market structure which is still competitive, but in which a major player is very highly geared and, as such, vulnerable. Its collapse, assumed to be a significant possibility, but not a probability, would leave the market much more concentrated and potentially very uncompetitive. Should this be disregarded; should the increased possibility itself be seen as a consumer interest detriment; or should there be specific reference in the Act, for example to the significant possibility of particularly detrimental outcomes, whether to competition or consumers. Equally should a merger be blocked on standard competition grounds where there is a significant possibility but less than 50 per cent that, absent the merger the target company will collapse?

This was all highlighted in the recent inquiry into electricity generators. Numerous issues were involved that I will not mention today, but one was the difference between the legal

framework facing the regulator, devising licence modifications to meet his responsibilities to consumers, and that facing the Commission the moment his proposed licence amendments were disputed. The legal question facing the Commission is whether a continuation of the licence without amendment may be expected to operate against the public interest. If, and I am now talking hypothetically, it was thought 30 per cent likely that, in the absence of the licence modification, the companies concerned would seek to manipulate the market to achieve excessive prices, then the regulator might reasonably seek the modification but the Commission would, absent any other considerations, have to disallow it. I am not certain of the right or best outcome in such a situation, but the present position was not, I suspect, foreseen or intended. More generally, a regime in which only those detriments which are likely to happen can be tackled is weaker than it need be. It is entirely a policy matter how strong the regime should be – the Commission will implement whatever regime emerges – but it is important to note, especially in the current climate, that there is an important policy issue involved here.

4) In passing, I will mention one important procedural implication of the merger reform.

There has been some pressure on the Commission to publish provisional conclusions, rather akin to Europe's Statement of Objections, before moving on, where appropriate, to consider remedies on a much less hypothetical basis than at present. I have been quite ready to contemplate such a change in the past, the main drawback being its implications for timetables. Business understandably emphasises the importance of speed in relation to merger inquiries and there is very strong evidence that, where provisional conclusions

of an investigation are published, timescales greatly lengthen. To the extent that Brussels avoids this it is because of a presumption, in the event of a Statement of Objections, that the merger will be blocked, it being for the companies concerned to persuade DGIV of a lesser but acceptable remedy in subsequent negotiations. The Competition Commission has to date had no legal basis for either a presumption of prohibition nor for any negotiation with parties.

The merger reform offers an opportunity to address these issues. I have therefore said that I intend in due course to incorporate the publication of provisional conclusions, provided ancillary changes can be put in place to avoid unacceptably long timescales. Amongst other things, these will include very specific time limits for each stage of the inquiry. In passing, in view of some press comment, I should add that this is not related to the judicial review of the Interbrew case. One of the many grounds claimed for appeal was that the company could not adequately consider remedies on a hypothetical basis, but the Court, as on all other points concerning our standard procedures, rejected this. Rather the procedural change would be an attempt to meet concerns of a more general nature on this point, provided the obvious risks can be dealt with.

REFORM OF THE COMPLEX MONOPOLY PROVISIONS

The merger reform proposals have been in the public domain for some time now, indeed, they reflect a lengthy process of consultation. It is only in the announcement nine days ago that a rather wider reform of the competition regime was announced, including a significant reform of the complex monopoly provisions of the Fair Trading Act.

In many respects these proposals are a read-across from the merger reform – independent authorities tackling complex monopolies in the light of a new test focussed specifically on competition, though the same considerations relating to a separate consumer interest leg will no doubt come to the fore. Also, it is not assumed that the complete independence (other than for EPI issues) envisaged in the merger reform will automatically read across in full. It is one thing for independent authorities to block a merger, which only takes the pattern of property rights back to the status quo ante. It is another for them to require divestment on assets previously owned and operated quite legally perhaps for many years. There may therefore need to be a residual power for ministers in the case of divestment remedies.

The proposed reforms have other important elements as well. There may be scope for the DGFT to make lesser references than a full scale complex monopoly reference, to allow the OFT to shine its searchlight across the whole UK industrial landscape, highlighting sectors where there may be some competition concerns and sending them forthwith to the Commission. This would, of course, imply more of a two-stage investigation for the Commission, the first seeking to identify whether a full scale inquiry was warranted, the corollary being that a number of such ‘fast-track’ inquiries would end up being dropped.

In addition, it is envisaged that the OFT generally, and the Commission in individual inquiries, will pinpoint and report on regulatory restrictions on competition, with a duty publicly to bring such situations to the Government’s attention, with a reciprocal duty on the Government to respond publicly to a tight deadline. This echoes and extends new powers for the OFT and

Commission in relation to financial services under the FSMA, where the OFT has a power to refer prudential or other FSA rules or guidelines to the Commission for investigation if it considers them potentially anti-competitive. The Commission will then report to the Treasury, which has indicated that in all but the most exceptional circumstances it will regard the findings as determinative.

As with mergers, I now focus on some economic aspects of this reform. The Government's announcement emphasises the value of the complex monopoly provisions in being able to address sectors with inadequate competition even though there is no single dominant firm and no suggestion of collaboration. Many have said that the absence of any such provisions for dealing with oligopoly are, or certainly have been, a weakness in the European regime which, via the notion of collective dominance, it is seeking to correct.

Several points are relevant. First, while complex monopoly is often equated with oligopoly, and clearly can embrace it, they are not synonymous; oligopoly is neither necessary nor sufficient for a complex monopoly to exist. This is because the definition of complex monopoly requires:

- a)* that two or more companies which together have more than 25 per cent of a market;
- b)* so conduct their respective affairs as in any way to prevent, restrict or distort competition.

Thus in one inquiry where doctors were all using insurance-related price lists to set prices for medical treatment, the Commission found over one-thousand complex monopolists—which hardly counts as oligopoly. But oligopolies may well exist in which, on the evidence, none of the oligopolists so conduct their respective affairs as to prevent, restrict or distort competition and so no complex monopoly exists. This all reflects that oligopoly as understood in economic

theory is a *structural* condition whereas complex monopoly as enshrined in statute is defined in terms of the *conduct* of market participants.

Many have commented that, whatever the view in 1973 (in practice much earlier) from the perspective of 2001 it looks odd that conduct found to prevent, restrict or distort competition is only a jurisdictional test. It is a separate and subsequent stage of a complex monopoly inquiry whether this involves any detriment to the public interest. Many suggest that the very fact of the prevention, restriction or distortion of competition should be grounds for an adverse finding. They view a change to reflect this as an important updating of the regime. But some US commentators would presumably dispute this. If as is widely claimed, the US regime is both the best and at the forefront of thinking, and if it has gone beyond focussing on competition to a focus on benefits to consumers and the economy, then a move to a specific competition-based test would, in their view, appear misguided.

Clearly a purely structural jurisdictional test, on a par with that of a scale monopoly—one company having more than 25 per cent of the market—is impossible. (Sectors where two or more companies have more than 25 per cent of the market are, I can say without fear of contradiction, rather common). But this does not mean that the reform could not move away from the conduct based test currently employed. For example, the DGFT could refer sectors where he had reason to believe that competition was inadequate: the Commission could investigate and determine whether that was true; and determine remedies for any inadequacies found, be they behavioural, structural or regulatory in form.

As with mergers, but perhaps more so here, behind the policy debate and the specifics of reform lurk a range of much more problematic issues. When the original Articles 85 and 86 of the Treaty of Rome were being drafted, and when UK competition policy was being formulated in the earlier post-war years, oligopoly theory was something of a Cinderella area in economics and, without question, indeterminate in terms of outcomes. The FTA was, in retrospect, very forward-looking in developing provisions that could tackle oligopoly, and wise in making no presumption as to the effect of oligopoly on competition or consumers. That is part of their strength 28 years later.

But there have been several revolutions in economic analysis since then. First conjectural variation analysis and then game theory were widely employed to generate determinate solutions leading towards a general proposition that, other things equal, increased concentration would, provided there were some barriers to entry (or later, barriers to contestability) generate higher prices and profits. Unfortunately this focused around the economic concept of ‘tacit collusion’. I say unfortunate because in legal terms it is not collusion of any sort—only a mutual recognition of the commercial sense in not seeking to undercut the prevailing level of prices. It did, however, focus the attention of competition authorities on to the conditions conducive to such behaviour, and this proved a very useful step forward. However, this new Jerusalem then rather crumbled as various characteristics of markets, and more specifically of information and decision logic, were taken into account, leading on to the view that oligopoly outcomes were path dependent and back, therefore, to indeterminacy.

As a result, the competition policy implications of recent developments in oligopoly theory are rather opaque, unless it is just to reiterate that it all depends on the circumstances. Given this state of affairs, the reforms announced last week may prefer to focus on a lack of competition, and it will then be for the authorities to determine whether this situation exists in each specific case, primarily relying on a more traditional but reasonably comprehensive check list of issues—structural, behavioural and performance related. The predominant question—what is the relative weighting that should be given to these—would then remain a matter for the authorities in the evolving regime.

On this question I personally remain resolutely eclectic. As regards any future regime, if the structure of a market is oligopolistic and there is evidence of a lack of competition then I am sufficiently Hayekian to reject the notion that a specific detriment must also have been demonstrated. The advantages of competition are too pervasive, too well attested and sufficiently unpredictable to justify adding the latter criterion as well. At the same time there cannot be a presumption that uncompetitive structure or behaviour automatically justifies intervention. Legitimate arguments may on occasion exist for believing that despite those circumstances, there are sufficient benefits to consumers to justify non-intervention. These cases may be a minority; there may need to be assessed with a sceptical stance; and it is probably right to expect that the benefits are both manifest, and unobtainable except by allowing a degree of uncompetitiveness to continue. But none of that prevents it being a relevant consideration. In short, specific detriments should not be a necessary condition, but specific benefits should be capable of being taken into account.

If this is so then it is right to maintain both types of criteria in the legislation with the balance left to the authorities. There is always an understandable demand for certainty in legislation—lawyers wish to be able to give their clients unequivocal advice on what is or is not permissible. But if what I have said is correct, the quest for certainty creates an unacceptable trade-off. Narrowly drawn certainty simply misses significant instances of uncompetitive activity; broadly drawn certainty catches too much activity, which is potentially inhibiting and excessively regulatory. The better option may be some discretion, guidelines and accumulated case evidence.

CONCLUSIONS

In conclusion, even an ever cynical UK press believes that there are some real and important changes in all this. Some of the underlying issues remain as controversial as ever—the relative importance of competition as a process versus what it delivers; how to combine a necessary degree of discretion with a proper regard for certainty in the regime; whether criminalisation of cartels will be effective—not to mention still widely differing views on the extent to which UK industry is or is not competitive, is or is not riddled with anti-competitive practices. Nor have I today touched on another very topical debate—the impact of globalisation, what this means both for competition analysis, for policy and for the extent of information sharing and other forms of co-ordination between authorities around the world. There are also significant implications for procedure, staffing and resources which I will not dwell on today.

There is an important element on continuity as well. Nearly all mergers have in practice been assessed against competition and consumer interest benchmarks; nearly all Commission

recommendations have in fact been implemented. There is a substantial track record of dealing with complex monopolies and even with pointing up regulatory restrictions on competition. In that sense the changes are evolutionary rather than revolutionary, but they will nonetheless, I believe, change substantially the environment within which industry operates.